



## International Transactions

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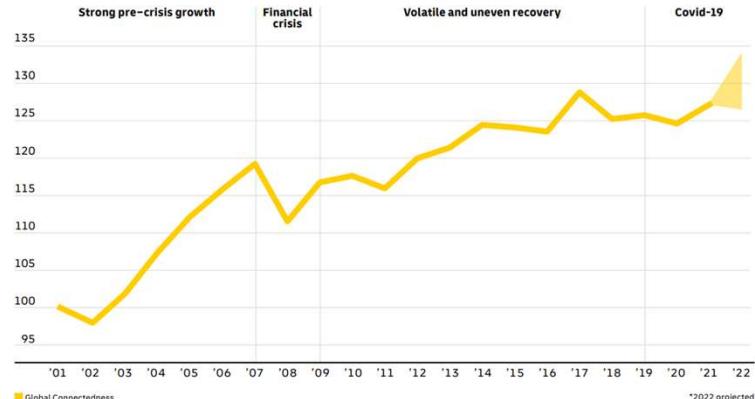
## Globalization!!!

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- Imagine an **American** driving to work in a car designed by **Germans**, assembled in **Mexico** from components made in **Japan**, fabricated from **Korean Steel** and **Malaysian rubber**.
- She may have filled the car with Petrol from **British Petroleum (BP)**. The Petrol could have been pumped from the coast of **Africa** by a **French** Oil company that transports it to **US** by a **Greek** Shipping Line.
- While driving she may have spoken to her stock broker on Apple i-phone, designed in **US**, manufactured in **China** from chips bought from **Taiwan**, that were designed by **Indian** Engineers working for Qualcomm in **India**.

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# The State of Global Connectedness

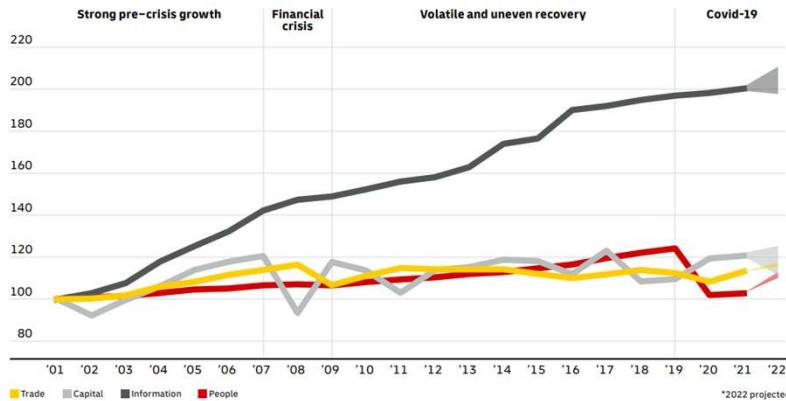


Source: DHL GLOBAL CONNECTEDNESS INDEX, 2001 – 2022

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## Pillars of Global Connectedness – Trade and Capital



Source: DHL GLOBAL CONNECTEDNESS INDEX, 2001 – 2022

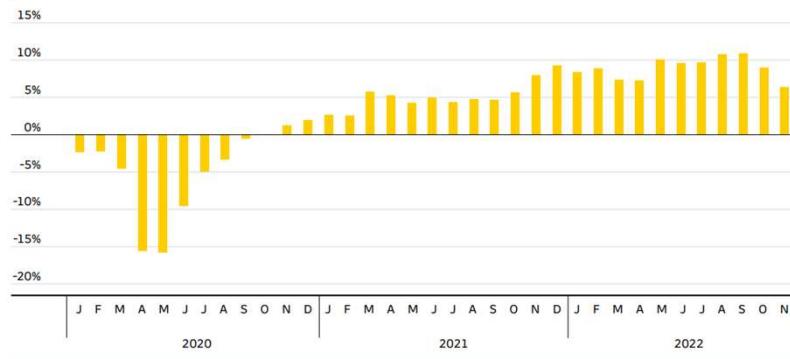
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## International Travel vs. Trade

**FIGURE 4: WORLD MERCHANTISE TRADE VOLUME (SEASONALLY ADJUSTED CHANGE VS. DECEMBER 2019)**



Source: DHL GLOBAL CONNECTEDNESS INDEX, 2001 – 2022

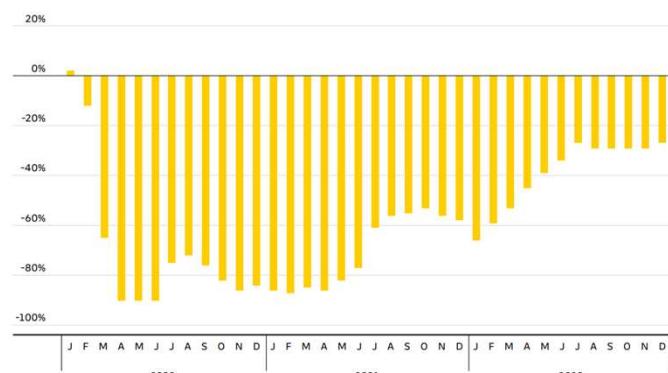
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## International Travel vs. Trade

**FIGURE 7: INTERNATIONAL TOURIST ARRIVALS, CHANGE VERSUS 2019**



Source: DHL GLOBAL CONNECTEDNESS INDEX, 2001 – 2022

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## Drivers of Globalization

### Declining Trade and Investment Barriers

- 1920s-30s: Barriers to **international trade and foreign direct investment**
  - High tariffs resulted in retaliatory trade policies
- GATT lowered barriers
  - Uruguay Round (1993)
  - Established World Trade Organization (WTO)

## Drivers of Globalization

### Average Tariff on Manufactured Products (%)

Country/Year	1913	1950	1990	2003
France	21	18	5.9	4
Germany	20	26	5.9	4
Italy	18	25	5.9	4
Japan	30	---	5.3	3.8
Holland	5	11	5.9	4
Sweden	20	9	4.4	4
Great Britain	---	23	5.9	4
United States	44	14	4.8	4

Source: The Economist, June 2004

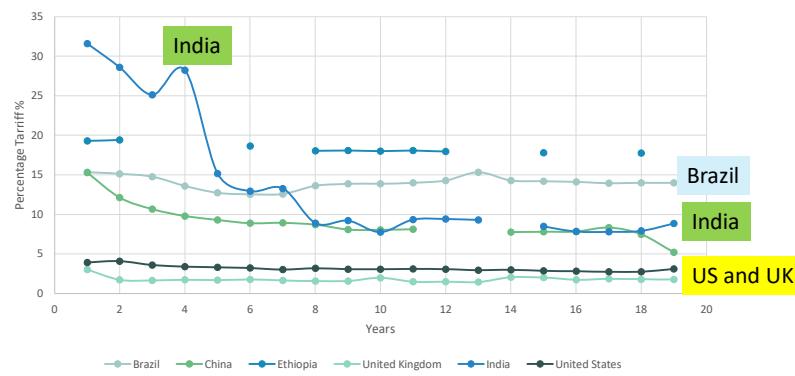
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## Emerging Economies

Import duties/ tariffs on manufactured products - 2001-2019 (%)



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# Drivers of Globalization

## Knowledge Society and Trade Agreements

- The value of world trade in merchandised goods has grown consistently faster than the growth rate in the world economy since 1950.
  - Trade across country borders has grown 26 times more than world production.
  - Knowledge society has produced more informed consumers, driving demand.
  - Removal of restrictions to FDI
  - More trade agreements

# Drivers of Globalization

## Role of Technological Change

- Communications
  - Development of the microprocessor
  - **Moore's Law**
- Internet of things
  - Half the world's population uses the Internet
  - Global e-commerce sales over \$2 trillion
  - The Internet is an equalizer
    - Helps overcome constraints of location and time zones

# Drivers of Globalization

## Role of Technological Change

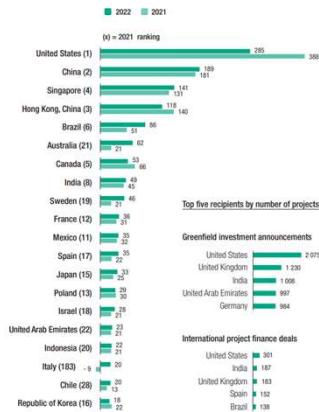
- Transportation technology
  - Commercial jet travel, superfreighters, and containerization
- Implications for the globalization of production
  - Has become more economical
  - Worldwide communications network
- Implications for the globalization of markets
  - Convergence of consumer tastes and preferences

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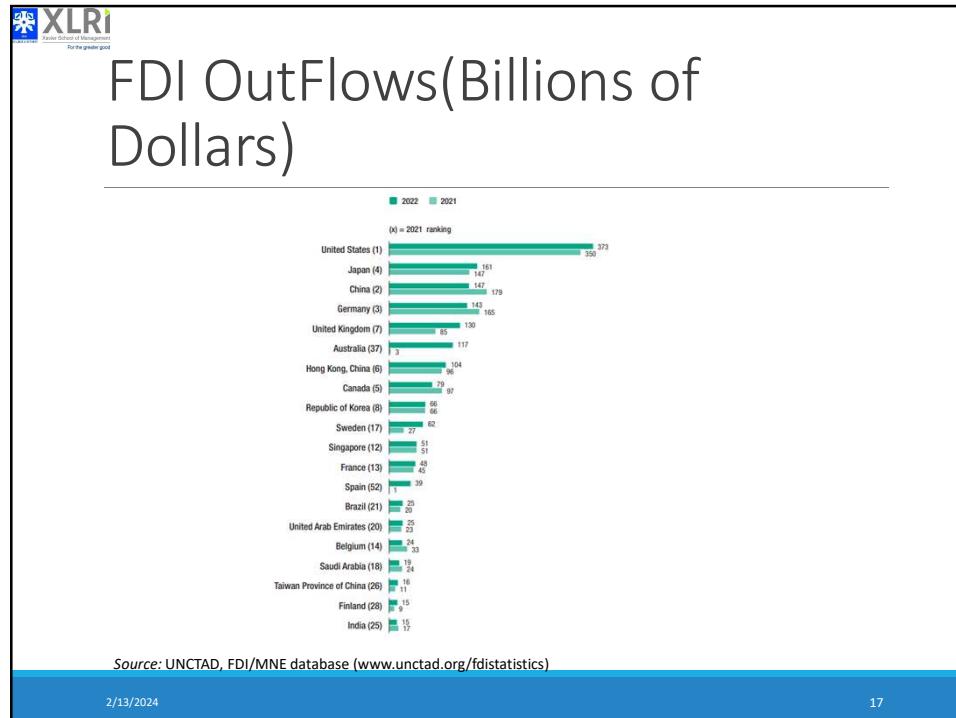
# FDI Inflows (Billions of Dollars)

Source: UNCTAD, FDI/MNE database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics))

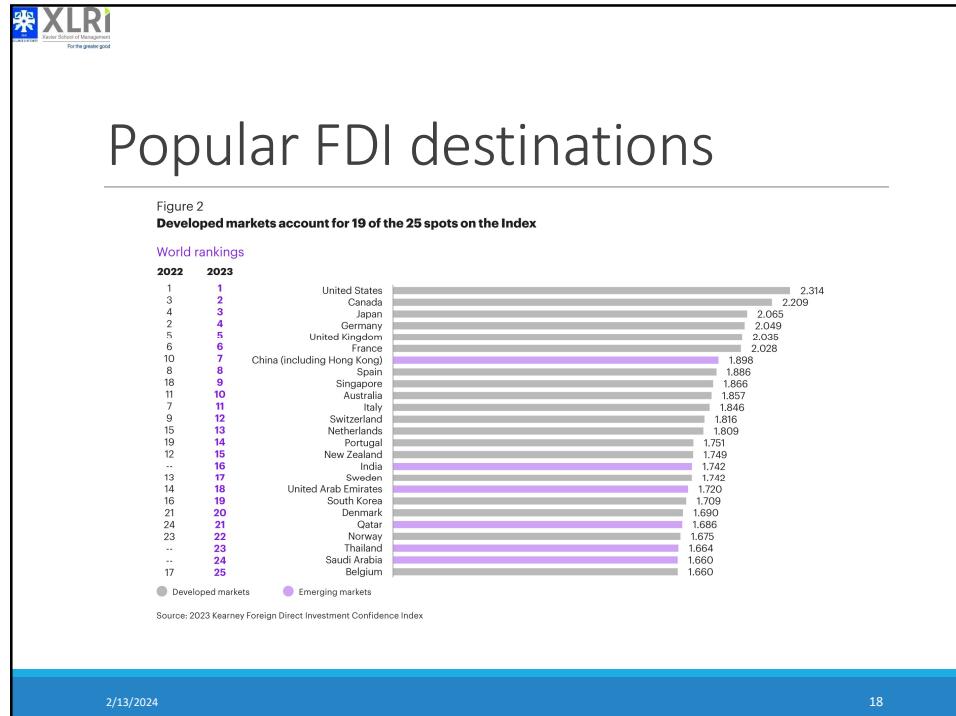
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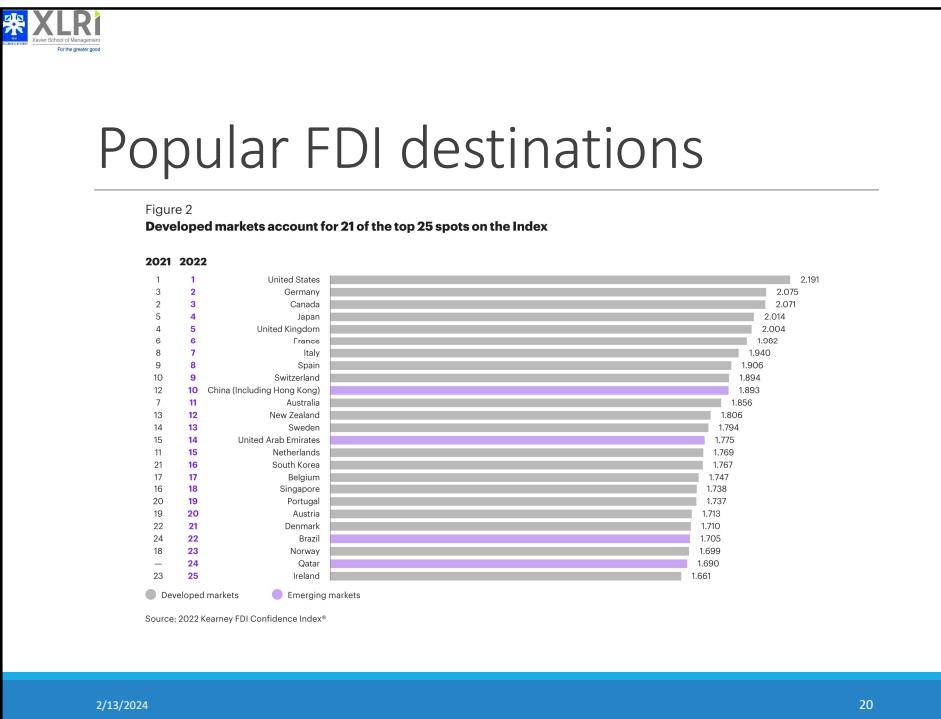
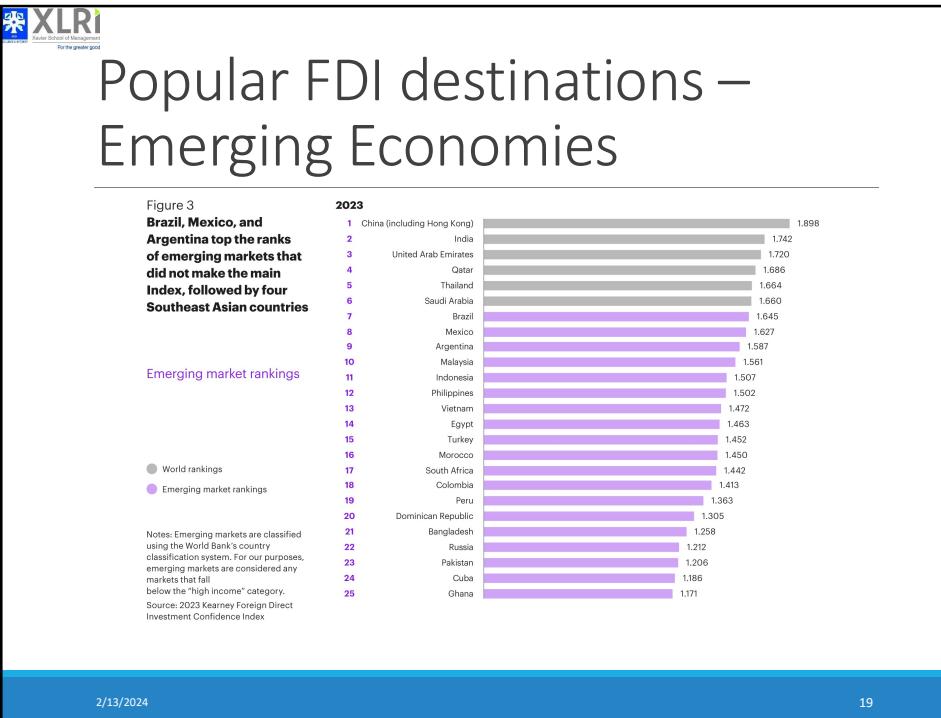
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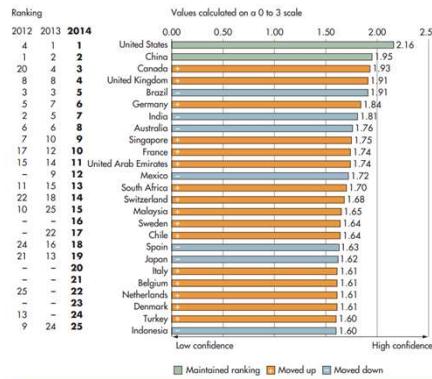
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## Popular FDI destinations



Source: 2014–2015 FDI Confidence Index, copyright A. T. Kearney, 2014. All rights reserved. Reprinted with permission.

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## New Trends in Globalization

- Change in Global Trends
  - Balance of growth toward emerging markets
  - Need for increased productivity and consumption in developed countries to stimulate their economies
- Rise of BRICS as an investment location
  - MINT becoming the new BRIC
- Shift from Globalization to regionalization and localization or “guarded globalization”
  - Developing nations sighting “nationalism” to protect their own industries
- Backlash against globalization
  - A reason for inequality among nations
  - New age imperialism

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## Why do firms internationalize?

Four broad reasons –

- 1. Market Seeking**
- 2. Natural Resource Seeking**
- 3. Efficiency Seeking**
- 4. Strategic Asset-Seeking**

### 1. Market Seeking

- Investment in foreign countries to increase sales
- Market seekers look for a larger market size and market growth
- Four main type of market seekers
  - Follow their customers or suppliers into foreign markets
    - Ex- Japanese auto component suppliers set up subsidiaries in countries with Japanese auto-assemblers
  - Need to adapt their products to local tastes or needs and to indigenous resources and capabilities
    - Overcome production and transaction costs associated with geographic distance, culture, language
  - In some cases, government regulations, import controls or strategic trade policy may prompt firms to relocate their production facilities
  - Physical presence in markets where a firm's competitors have a physical presence

## 2. Natural Resource Seeking

- Investment in foreign countries to acquire resources of a higher quality at a lower real cost than could be obtained in firm's home country.
- Both developed and developing countries engage in such internationalization.
- MNEs seek mineral fuels, industrial minerals, metals and agricultural products etc.
  - Especially those whose production requires the kind of complementary capabilities and markets that MNEs are especially well equipped to provide.
- This is a popular motive of internationalization of Indian and Chinese MNEs in Africa

## 3. Efficiency Seeking

- Combination of both market seeking and resource seeking
- MNEs can seek efficiency through foreign investment by -
  - Accessing cheap and well-motivated unskilled or semi-skilled labor.
  - Taking advantage of different factor endowments, economic policies and by concentrating production in a limited number of locations
    - Mexico, Taiwan and Malaysia preferred locations for labor.
    - Recently countries like China, Vietnam, Turkey, Morocco and Mauritius have become favored locations.
  - By investing in countries with similar economic structures and income levels to take advantage of the economies of scale and scope.

## 4. Strategic Asset Seeking

- MNEs aim at augmenting their global portfolio of physical assets and human competences
- Mainly done to acquire technological capabilities, brands, patents, established R&D units etc.
- A popular motive of internationalization of emerging economy firms i.e. firms from India, China etc.
  - Ex: Acquisition of IBM's PC business by the Chinese firm Lenovo in 2005, and the Indian firm Tata's purchase of the UK steel giant Corus in 2007
  - Acquisitions and joint ventures are popular modes of strategic asset-seeking.

## Other motives of internationalization

### Escape

- Foreign investments are made to escape restrictive legislation, taxes or macro-organisational policies by home governments.
  - Ex: 'round-tripping' of investment between China and Cayman Islands, British Virgin Islands to exploit incentives granted only to foreign investors.
  - Indian firms investing in tax heaven like Mauritius, Cayman Islands etc.

### Support investments

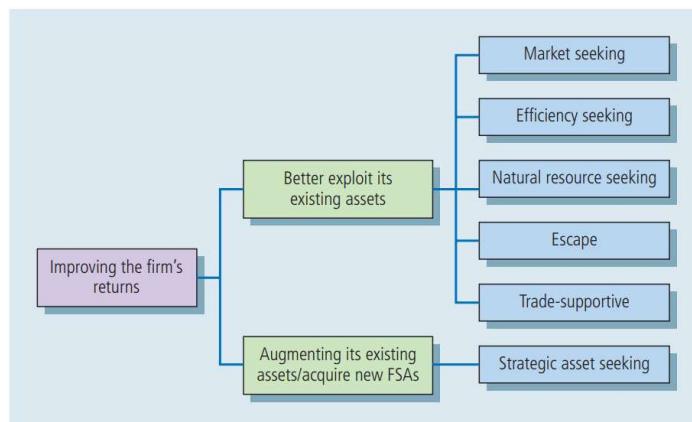
- The main purpose of such investments is trading and finance
- Foreign investments are done in subsidiaries to support the activities of the rest of the enterprise of which they are part.
  - Ex: Sears Roebuck, Kmart, Wal-Mart, etc. purchase substantial quantities of clothing and footwear from Asian suppliers, through their buying subsidiaries.

# Other motives of internationalization

## Passive investments

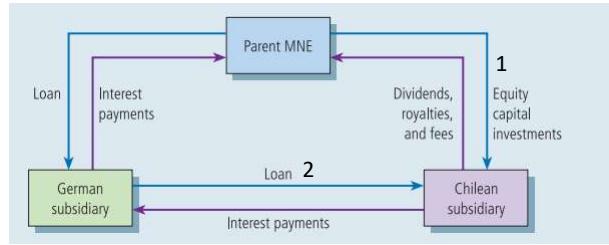
- Usually done as “portfolio investments”
- Main idea is to gain higher appreciation of capital
  - Ex – Investment of ‘petrodollars’ by Gulf companies in real state, hotels etc. in markets like London.
- Passive investors usually don’t take an active part in the management of the organization but may at times discipline management
- Such investments are undertaken to improve the technological, marketing, financial and organizational capabilities of the invested firm
  - Passive investments in Reliance Industries - Facebook, Google, Silver Lake, Vista Equity Partners, General Atlantic, KKR, Mubadala, ADIA, TPG, L Catterton, Public Investment Fund of Saudi Arabia, Intel Capital and Qualcomm Ventures etc.

# The Decision Model



# Managing Global Cash Flows

## Internal funds flows



Factors that influence the decision –

1. Tax rates

The MNE will not prefer a subsidiary in a high tax regime to get its interest income to be taxed at a higher rate

2. Government policies

# Managing Global Cash Flows

Transfer price is an internal price that is set by a company in intrafirm trade

	Arm's-length price		Transfer price	
	Country A	Country B	Country A	Country B
Sales	\$10,000 exports	\$12,000	\$12,000 exports	\$12,000
Costs of sales	8,000	10,000	8,000	12,000
Profit	2,000	2,000	4,000	Nil
Tax rate (A: 40%, B: 50%)	800	1,000	1,600	Nil
Net profit	1,200	1,000	2,400	Nil

# Managing Global Cash Flows

## Use of tax havens

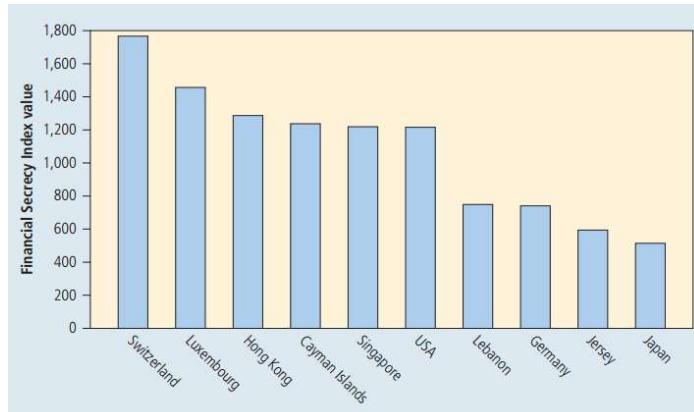
	Country A subsidiary	Country B subsidiary (tax haven)	Country C subsidiary
Sales	\$8,000 exports	\$12,000 exports	\$12,000
Costs of sales	8,000	8,000	12,000
Profit	—	—	—
Tax rate (A: 40%, B: 0%, C: 50%)	—	—	—
Net profit	0	4,000	0

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## World's top tax havens based on Secrecy Index value, 2015



Source: City A.M., "Mapped: the world's biggest tax havens," February 12, 2015

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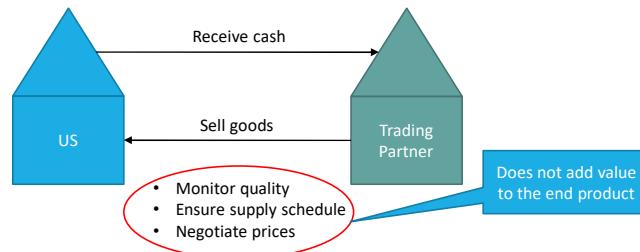
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# TRANSACTION COST ECONOMICS

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## Transaction Costs

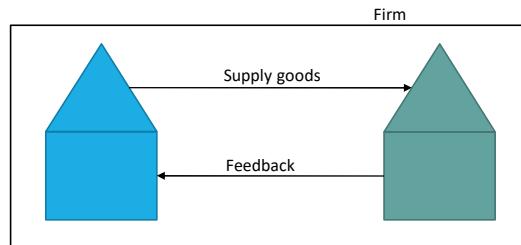
Scenario 1



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## Transaction Costs

Scenario 2



Communicate through email or physical meetings

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## Transaction Costs

- If costs of ‘doing the activity yourself’ is less than “outsourcing” it to an external partner, then internalizing the activity is a better option.
- If costs of “outsourcing” is less than “doing it yourself”, outsourcing is a better option.
- Costs of outsourcing may include –
  1. Negotiating prices, delivery schedule
  2. Writing contracts
  3. Enforcing contracts
  4. Monitoring output

} Transaction Costs

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# Transaction Costs in International Business

**Transaction costs in international business arise due to -**

- Cost of gathering information about host country partners
  - Information regarding their conduct, credibility, trustworthiness
- Cost of negotiating and contracting with host country suppliers, partners, customers
- Cost of monitoring host country partners and suppliers

**Transactions costs increase with -**

- Unclear regulatory frameworks, inexperienced bureaucrats, under developed court systems and corruption
- Weaker protection for intellectual property
- Differences in culture and institutional set ups of two countries
- **MNEs have to weigh in whether setting up own operations is a cheaper option taking transaction costs into account**

# What factors determine foreign investment?

## The OLI Framework

- Three factors that determine the international activities of multinational enterprises (MNEs).
- **(O)wnership advantages**
- **(L)ocation advantages**
- **(I)nternalization advantages**
- It states that - MNEs develop competitive 'O' advantages at home and then *transfer* these to foreign countries (depending on L advantages) through FDI
  - FDI is a preferred mode of internationalization when there are 'internalization' benefits

## The OLI Framework

### Ownership Advantages (Oa, Oi)

- Firm's intangible assets, such as knowledge, brands, organizational structure, and management skills, and
- Access to home country advantages available to the firm like natural resources; manpower; capital.

### Location Advantages

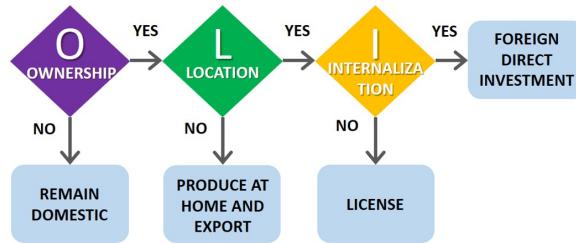
- Market size, natural resources, aspects of the infrastructure, the education system, governance structures, and other aspects of political and government activity.

### Internalization Advantages

- These accrue to firms if FDI reduces 'transaction costs' of doing business in foreign markets.

## FDI?

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## Trade Theories

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## Mercantilism (mid-16<sup>th</sup> century)

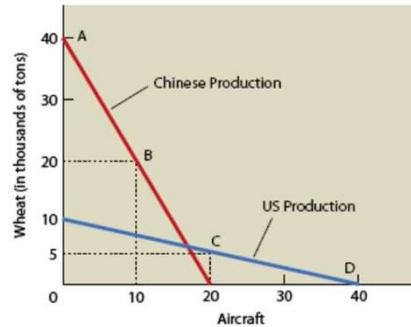
- It is in a country's best interest to maintain a trade surplus—to export more than it imports
- Advocates government intervention to achieve a surplus in the balance of trade
- Surplus measured in money (i.e. gold) rather than in goods or in terms of economic outcomes
- Mercantilism views trade as a zero-sum game—one in which a gain by one country results in a loss by another
- Intellectual ancestor of **protectionism** – idea that governments should actively protect domestic industries from imports and promote exports.
- Walmart, though a leading US retailer, is actually making US poorer!!!

## Absolute Advantage

- **Absolute advantage** refers to a situation in which a country has an absolute advantage in the production of a product when it is more efficient than any other country at producing it.
- Countries should specialize in the production of goods for which they have an absolute advantage and then trade these goods for goods produced by other countries
- Both countries benefit from specialization and trade

## Absolute Advantage

With free trade, a nation gains by specializing in economic activities in which it has an absolute advantage.



What if a country does not have absolute advantage in producing any good or service?  
Should it not trade?

## Absolute Advantage (Adam Smith, 1776)

Total units of resources = 800 for each country		Wheat	Aircraft
1. Resources required to produce 1,000 tons of wheat and 1 aircraft	China US	20 resources 80 resources	40 resources 20 resources
2. Production and consumption with no specialization and without trade (each country devotes half of its resources to each activity)	China (point B) US (point C) <i>Total production</i>	20,000 tons 5,000 tons 25,000 tons	10 aircraft 20 aircraft 30 aircraft
3. Production with specialization (China specializes in wheat and produces no aircraft, and the United States specializes in aircraft and produces no wheat)	China (point A) US (point D) <i>Total production</i>	40,000 tons 0 40,000 tons	0 40 aircraft 40 aircraft
4. Consumption after each country trades one-fourth of its output while producing at points A and D, respectively (scenario above)	China US <i>Total consumption</i>	30,000 tons 10,000 tons 40,000 tons	10 aircraft 30 aircraft 40 aircraft
5. Gains from trade: Increase in consumption as a result of specialization and trade (scenario 4 versus scenario 2 above)	China US	+10,000 tons +5,000 tons	0 +10 aircraft

# Comparative Advantage (Ricardo, 1817)

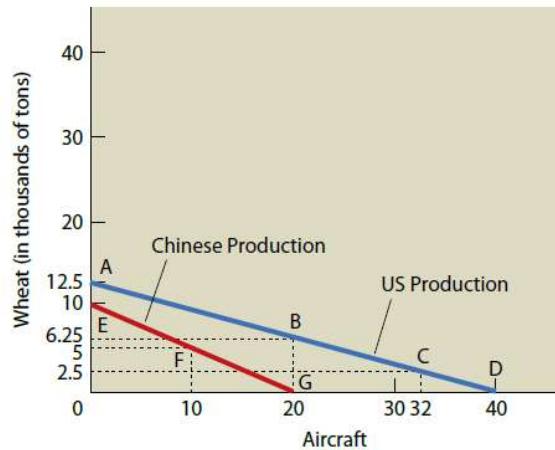
- A country should specialize in the production of those goods that it produces most efficiently
  - and buy the goods that it produces less efficiently from other countries, even if it can produce those goods more efficiently itself
- Proponents of this theory suggest that potential world production is greater with unrestricted free trade than it is with restricted trade.
- Trade is a positive-sum game in which all countries that participate realize economic gains.

# Comparative Advantage

Total units of resources = 800 for each country		Wheat	Aircraft
1. Resources required to produce 1,000 tons of wheat and 1 aircraft	China US	80 resources 64 resources	40 resources 20 resources
2. Production and consumption with no specialization and without trade (each country devotes <i>half</i> of its resources to each activity)	China (point F) US (point B) <i>Total production</i>	5,000 tons 6,250 tons 11,250 tons	10 aircraft 20 aircraft 30 aircraft
3. Production with specialization (China devotes all resources to wheat, and the United States devotes one-fifth of its resources to wheat and four-fifths of its resources to aircraft)	China (point E) US (point C) <i>Total production</i>	10,000 tons 2,500 tons 12,500 tons	0 32 aircraft 32 aircraft
4. Consumption after China trades 4,000 tons of wheat for 11 US aircraft while producing at points E and C, respectively (scenario above)	China US <i>Total consumption</i>	6,000 tons 6,500 tons 12,500 tons	11 aircraft 21 aircraft 32 aircraft
5. <i>Gains from trade:</i> Increase in consumption as a result of specialization and trade (scenario 4 versus scenario 2 above)	China US	+1,000 tons +250 tons	+1 aircraft +1 aircraft

## Comparative Advantage

The relative advantage in one economic activity that a nation enjoys over others.



## Understanding International Trade Agreements

- The evolution of **NAFTA** to **USMCA** offers a significant example. Originally established in 1994 to foster trade between the USA, Canada, and Mexico, NAFTA was replaced by USMCA (United States-Mexico-Canada Agreement) in 2020 to address modern trade challenges and opportunities. USMCA includes digital trade provisions and stricter automotive manufacturing rules to encourage regional production.
- **EXAMPLE:** The automotive industry under USMCA had to adapt significantly. With the requirement that **75% of auto content be made in North America (up from 62.5% under NAFTA)**, companies like General Motors and Ford had to re-evaluate and often reshuffle their supply chains to meet these new requirements, impacting sourcing and manufacturing decisions across the continent

## Free Trade is Beneficial - Assumption

- Simple world with 2 countries and 2 goods
- No transportation costs
- No differences in price of resources
- Resources can move freely
- Constant returns to scale
- Each country has a fixed stock of resources and free trade does not change the efficiency with which a country uses its resources
- No effects of trade on income distribution within a country

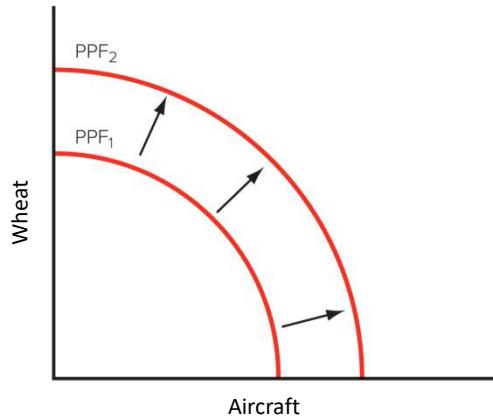
## Extensions of the Ricardian Model

- Immobile resources
  - Resources do not always move easily from one economic activity to another
  - Political opposition to the adoption of a free trade regime typically comes from those whose jobs are most at risk
- Diminishing returns
  - **The model assumes constant returns to specialization**
  - But actually there are - diminishing returns to specialization
    - All resources do not have the same quality
      - Ex – Land quality, labor productivity may not be fixed
    - Different goods use resources in different proportions
      - Ex – Aircraft may require more resources than wheat production or vice-versa. Leading to adoption of more labor intensive techniques and inefficiency.

# Extensions of the Ricardian Model

- Dynamic Effects and Economic Growth
- Trade can result in dynamic changes
  - Free trade might increase a country's stock of resources as increased supplies of labor and capital from abroad become available for use within the country.
  - Free trade might also increase the efficiency with which a country uses its resources.
- Dynamic gains in both the stock of a country's resources and the efficiency with which resources are utilized will cause a country's PPF to shift outward.

# Extensions of the Ricardian Model



PPF: Production possibility frontier

# Extensions of the Ricardian Model

- Trade, Jobs and Wages: The Samuelson Critique
  - What happens when a rich country (U.S.) enters into a free trade agreement with a poor country (China) that rapidly improves its productivity after the introduction of a free trade regime?
  - Lower prices may not make up for lower wages in the U.S.
- Historically, free trade has benefited wealthy countries.
- Protectionist measures may be harmful.
- Evidence for the link between trade and growth
  - Countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade.

# Realities of International Trade

- Trade barriers do exist
- A Microsoft X-Box costs \$ 360 in US but \$ 1000 in Brazil
- Chinese tyres invite 35% import duty in US that means US truck drivers pay 35% extra for the same tyre as compared to his Chinese counterpart
- India hiked import duties on roughly 30 products recently
  - Levies on solar lamps and cells are now between 15 and 20% from a previous 5%.
  - Cellphone charging devices, which were tariff free, were slapped with a 10% levy.
  - Reason is to reduce the volume of Chinese imports

## Barriers to Free Trade

- **Tariff Barriers** – means of discouraging imports by placing a tariff (tax) on imported goods.
  - Costly to organize for individuals and firms in scattered countries to make the case for free trade.
- **Non-tariff barriers** – discourages imports by means other than tariffs:
  - Subsidies
  - Import quotas
  - Voluntary export restraints
  - Local content requirements
  - Administrative policies
  - Antidumping duties

## Arguments against free trade

- **Economic**
  - Protect domestic industries
  - Shield infant industries

# Arguments against free trade

## ■ Political

- National security
  - Ex – France, India insist on manufacturing defense equipment even though its is costlier than importing
- Consumer protection
  - Ex – In early 2000, a single case of mad cow disease in Canada, led US government to ban all beef imports from Canada
- Foreign policy
  - Ex – Arab companies maintain embargos against Israel; US has embargoed against Iran, Syria, Cuba, North Korea
- Environmental responsibility
  - Ex - US banned shrimp imports from India, Pakistan, Malaysia and Thailand because shrimp catching technique also caught ‘turtles’, which are an endangered species
- Social responsibility
  - Ex - Germany has recently threatened to ban carpet imports from India citing usage of child labour

# Competitive Advantage of Nations - Michael Porter

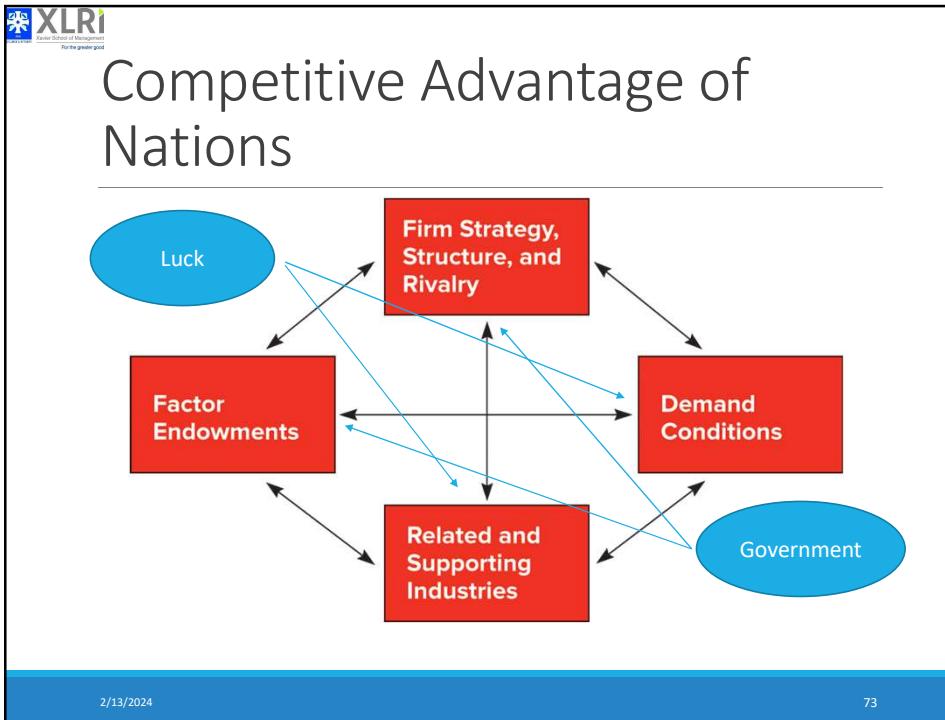
- How do companies succeed in International Markets?
- Through some source of competitive advantage?
- Which comes from some sort of innovation?
- Innovations are driven by **pressures, necessity or adversities?**
  - “The fear of loss proves to be more powerful than hope of gain”
- Once a firm achieves competitive advantage, it can sustain only through relentless improvement
  - Because almost any advantage can be imitated
  - Sooner or later, more dynamic rivals will find a way to innovate around the advantages and create a better or cheaper way of doing things
  - The option left to the firm is to “**upgrade**”

# Competitive Advantage of Nations - Michael Porter

- Why Italian shoes are the best?
- Why are more Bio-tech firms in US?
- Why are Swiss Pharma firm successful?
- Why are Japanese electronics and German auto firms popular?
- Why are Indian IT firms so competent?
- **Why does a nation achieve international success in a particular industry?**
  - Is it driven by macroeconomic phenomenon, such as exchange rates, interest rates, and government deficits?
  - Or cheap and abundant labor or natural resources?
  - Or is it because of protectionist government policies?
- Productivity???
- High quality, feature rich products produced per unit of labor

# Competitive Advantage of Nations - Michael Porter

- Four broad attributes of a nation shape the environment in which local firms compete
  - Factor endowments
  - Demand conditions
  - Related and supporting industries
  - Firm strategy, structure, and rivalry



# Competitive Advantage of Nations

## 2. Demand Conditions

- Firms gain competitive advantage if their domestic consumers are sophisticated and demanding
- For example, Japanese consumers, who live in small, tightly packed homes, contend with hot, humid summers
- In response, Japanese companies have pioneered compact, quiet air-conditioning units powered by energy-saving rotary compressors.
- The tightly constrained requirement of Japanese market have forced companies to innovate, yielding products that are ***kei-haku-tan*** ***sho—light, thin, short, small*** and are now internationally accepted

# Competitive Advantage of Nations

## 3. Related and Supporting Industries

- Availability of competitive suppliers create advantage in down stream industries
- Example – Swiss pharmaceutical industry's success emerged out of previous internationalized 'dye' suppliers
- High-end research institutions drive US pharma, biotech and defense industries success

# Competitive Advantage of Nations

## 4. Firm Strategy, Structure, and Rivalry

- Domestic rivalry is the most powerful factor in determining a nation's competitiveness
- Pressurizes incumbents to improve, innovate and become more productive
- In Switzerland, there is rivalry among its pharmaceutical companies, Hoffmann-La Roche, Ciba-Geigy, and Sandoz
- In Japan, there are 112 companies competing in machine tools, 34 in semiconductors, 25 in audio and tele-equipment, 15 in cameras
- Geographic concentration enhances rivalry
  - Italian jewellery companies are co-located around two towns, Arezzo and Valenza Po;
  - Pharmaceutical companies in Basel, Switzerland;
  - Motorcycles and musical instruments in Hamamatsu, Japan.

# Competitive Advantage of Nations

Two more factors –

## 1. Government

- Government plays the role of *a catalyst and challenger*
- Governments should encourage and push companies to raise their aspirations and move to even higher levels of competitiveness.
- This can be done by
  - Stimulating early demand for advanced products (demand factors);
  - focusing on specialized factor creations such as infrastructure,
  - the education system and the health sector (factor conditions);
  - promoting domestic rivalry by enforcing anti-trust laws;
  - and encouraging change.

## 2. Luck

- Y2K for Indian IT sector



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# Thank You.....